

GAO

Testimony

Before the Task Force on Defense and International
Relations, Committee on the Budget, House of
Representatives

For Release on Delivery
Expected at
10 a.m.
Thursday,
July 20, 2000

DEPARTMENT OF
DEFENSE

Implications of Financial
Management Issues

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G A O

Accountability * Integrity * Reliability

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Mr. Chairman and Members of the Task Force:

I appreciate the opportunity to discuss financial management issues at the Department of Defense (DOD) and their implications for the budget process. We recently testified¹ before the House Subcommittee on Government Management, Information and Technology on the status of DOD's efforts to address its long-standing pervasive weaknesses in financial management systems, operations, and controls. Material financial management deficiencies identified at DOD, taken together, continue to represent the single largest obstacle that must be effectively addressed to achieve an unqualified opinion on the U.S. government's consolidated financial statements. DOD's vast operations—with an estimated \$1 trillion in assets, nearly \$1 trillion in reported liabilities and a reported net cost of operations of \$378 billion in fiscal year 1999—have a tremendous impact on the government's consolidated reporting.

To date, no major part of DOD has yet been able to pass the test of an independent audit; auditors consistently have issued disclaimers of opinion because of pervasive weaknesses in DOD's financial management systems, operations, and controls. Such problems led us in 1995 to put DOD financial management on our list of high-risk areas vulnerable to waste, fraud, abuse, and mismanagement, a designation that continued in last year's update.² Lacking such key controls and information not only hampers the department's ability to produce timely and accurate financial information, but also significantly impairs efforts to improve the economy and efficiency of its operations. Unreliable cost and budget information affects DOD's ability to effectively measure performance, reduce costs, and maintain adequate funds control, while ineffective asset accountability and control adversely affect DOD's visibility over weapons systems and inventory.

DOD has made genuine progress in many areas throughout the department, both larger steps forward and smaller incremental improvements. We have seen a strong commitment by the DOD Comptroller and his counterparts in the military services to address the department's serious financial management problems. At the same time, DOD has a long way to go. Major problems remain—problems that are

¹ *Department of Defense: Progress in Financial Management Reform* (GAO/T-AIMD/NSIAD-00-163, May 9, 2000).

² *High-Risk Series: An Overview* (GAO/HR-95-1, Feb. 1995), *High-Risk Series: Defense Financial Management* (GAO/HR-97-3, Feb. 1997), and *Major Management Challenges and Program Risks: A Governmentwide Perspective* (GAO/OCG-99-1, Jan. 1999).

pervasive, long-standing, deeply rooted, and complex in nature. Our previous testimony outlined DOD's most difficult financial management challenges and described the many initiatives that are under way or planned to address them.

Today, I will highlight certain of those ongoing challenges, with a focus on those that affect the reliability of budget execution data as well as other areas where accurate and complete financial management information could provide a useful perspective to decisionmakers related to budget requests, performance measures, costs, and other key decision points.

Finally, I will discuss DOD's plans and actions to develop an integrated financial management system that complies with federal system standards. To achieve what the Comptroller General has referred to as the "end game"—systems and processes that routinely generate good financial information for day-to-day management purposes—will require a major systems and reengineering effort. Integrated financial management systems, along with marshaling the human capital needed to achieve results, have long been cited as major components to the final resolution of DOD's financial management problems. The successful Year 2000 effort demonstrated that DOD can resolve complex, entitywide problems through top management leadership working across functional lines. Applying the Year 2000 lessons learned to the department's financial management system integration effort will require similar leadership and commitment to a disciplined systems development approach.

Reliability of Budget Execution Data Impaired

As an integral part of an effective budget execution system, an agency is responsible for determining and maintaining its available fund balance. Treasury also has information about activity in the agency's accounts, and Treasury's and the agency's records must be periodically reconciled to determine the actual amount of funds available. This is analogous to reconciling one's personal checking account with the monthly bank statement. DOD weaknesses in accounting for its funds include (1) the inability to reconcile its balances to Treasury's, (2) frequent adjustments of recorded payments from one appropriation to another appropriation account, including to canceled appropriations, (3) problem disbursements—disbursements that are not properly matched to specific obligations recorded in the department's records, and (4) obligated balances that are incorrect or unsupported.

As a result of these weaknesses, auditors have been unable to verify DOD's Fund Balance With Treasury and its major components—obligated and unobligated balances. This means that DOD does not know with

certainty the amount of funding that is available. This information is essential for DOD and the Congress to be able to determine the status of funds and if unobligated balances are available that could be used to reduce current funding requirements or that could be reprogrammed to meet other critical program needs.

Significant Differences Between DOD's and Treasury's Records

Although DOD has made some improvements in its accountability over its fund balance with Treasury, the amount of funds available at DOD remains questionable because (1) significant differences between DOD's and Treasury's records remain, (2) the reduction in differences between Treasury's and DOD's recorded fund balances may be, in part, a result of a change in policy rather than an actual reduction, and (3) items in suspense accounts, which cannot be identified with a specific appropriation account, may not be DOD transactions.

DOD made the reduction of differences a high priority in its short-term improvement plans last year. There was a drop in the amount of the unresolved differences from \$9.6 billion at September 30, 1998, to \$7.3 billion at September 30, 1999. Although some of the differences may be due to the timing of transaction processing at Treasury versus DOD, an aging of the difference suggests that significant reconciliation issues remain. For example, of the \$7.3 billion difference, \$2.5 billion is 60 days or older. Differences over 60 days old are generally not attributable to timing.

At least some of the decrease in the total differences as of September 30, 1999, can be attributed to the practice of some Defense Finance and Accounting Service (DFAS) center staff to routinely adjust their records each month to match those at Treasury without first identifying whether the adjustment is proper. This practice results in fewer differences on the reports but does not necessarily mean that the reconciliation process has actually improved or that the causes of the differences, such as Treasury or DOD errors in recording transactions, have been addressed and resolved. For example, one Army disbursing station recorded \$608 million in differences to a suspense account.³ At year-end, DOD charged the differences to Army's Operations and Maintenance appropriation, without documentation to support that these transactions should be recorded to this account. This resulted in financial reports to the Congress and OMB that show a reduction in the obligated balance in that account available for

³A suspense account is a temporary holding account for problem transactions involving both collections and disbursements—for example, those rejected because of system edit controls.

disbursement. However, DOD has little assurance that the charge should not have been properly assessed against, for example, some other Army appropriation or even to another entity's appropriation. Further, at the beginning of the next fiscal year, DOD reversed the Operations and Maintenance charges and returned the amounts to suspense accounts.

Finally, DOD records show that an estimated \$1.6 billion of transactions held in suspense accounts at the end of fiscal year 1999 have not been properly reported to Treasury and may also affect the fund balance with Treasury amount. Until suspense account transactions are posted to the proper appropriation account, the department will have little assurance that appropriation balances are accurate, and that it has a right to any collections, that adjustments are valid, and that the disbursements do not exceed appropriated amounts. Moreover, the reported amounts in suspense accounts represent the offsetting (netting) of collections and adjustments against disbursements, thus understating the magnitude of the unrecorded amounts in suspense accounts. To illustrate the magnitude of this issue, we previously testified⁴ that audit work for fiscal year 1997 found that while the Navy had a net balance of \$464 million in suspense accounts recorded in its records, the individual transactions—collections as well as disbursements—totaled about \$5.9 billion.

Frequent Adjustments Affect Reliability

DOD frequently adjusts recorded payments to transfer the payment to another appropriation account, including to canceled appropriations. These adjustments raise questions about the reliability of amounts reported as obligated and available for disbursement in specific appropriations. In March 2000, we reported⁵ that about one of every two dollars in fiscal year 1997 contract payment transactions processed was for adjustments to previously recorded disbursement transactions. Although DOD reported that the number of adjustments has declined, it remains significant. During fiscal year 1999, DFAS data showed that almost one of every three dollars in contract payment transactions was for adjustments to previously recorded payments—\$51 billion in adjustments out of \$157 billion in transactions. Adjustments were often made to original entries that were recorded years earlier. A number of the adjustments selected during our review were made to canceled accounts.

⁴*Department of Defense: Status of Financial Management Weaknesses and Actions Needed to Correct Continuing Challenges* (GAO/T-AIMD/NSIAD-99-171, May 4, 1999).

⁵*Financial Management: Differences in Army and Air Force Disbursing and Accounting Records* (GAO/AIMD-00-2, Mar. 7, 2000).

In the National Defense Authorization Act for Fiscal Year 1991, the Congress changed the government's account closing procedures. The intent of the changes was to impose the discipline of the Antideficiency Act⁶ and the bona fide needs rule⁷ to expired appropriations and to ensure that expired appropriations do not remain open on the government's books indefinitely.⁸

Subsequent to the amendment of the account closing law, DOD requested that Treasury reopen hundreds of closed accounts to permit the posting of adjustments. Treasury asked us whether it had authority to correct reporting or accounting errors in closed accounts. In 1993, we determined that Treasury had authority to correct these errors.⁹ The decision concluded that Treasury may adjust the records of canceled appropriations to record disbursements that were in fact made before the cancellation. However, Treasury can make these adjustments only if DOD can establish that a disbursement was a liquidation of a valid obligation, recorded or unrecorded, that was properly chargeable against the account before it closed.¹⁰

Adjusting disbursements previously recorded to current accounts by moving those transactions to canceled accounts can increase balances available for obligation in the current accounts. Since the 1991 account closing law was enacted, DOD has requested that Treasury reopen 333 closed accounts, totaling \$26 billion. These accounts remained open as of September 30, 1999. By comparison, all other federal agencies combined have requested that Treasury reopen 21 closed accounts, totaling \$5 million. According to Treasury's records, DOD made \$576 million in net

⁶The Antideficiency Act provides that an officer or employee of the United States Government may not "make or authorize an expenditure or obligation exceeding an amount available in an appropriation or fund" or enter into a contract or other obligation for payment of money "before an appropriation is made." (31 U.S.C. 1341 (a)).

⁷The bona fide needs rule, based on 31 U.S.C. 1502(a), requires that agencies use appropriations available for obligation for a limited period of time to meet the legitimate needs of the agency arising during that period of time.

⁸Under the account closing law, 31 U.S.C. 1551-1558, agencies must continue to account for the obligated and unobligated balances of their appropriations for 5 years after the expiration of their period of availability. At the end of 5 years, appropriation balances, both obligated and unobligated, are canceled. After that time, they are no longer available for obligation, obligation adjustment, or expenditure for any purposes. Because these accounts are no longer available for disbursement, they are not reported as part of DOD's Fund Balance with Treasury or in the department's Status of Funds reports to OMB or the Congress.

⁹72 Comp. Gen. at 343 (1993).

¹⁰72 Comp. Gen. at 347 (1993).

adjustments to canceled accounts in fiscal year 1999. DOD has indicated that it has controls in place to ensure that adjustments to canceled accounts are proper. Chairman Kasich and Chairman Horn recently asked us to review DOD's practice of making adjustments to canceled accounts, and our work has just begun.

Disbursements Not Properly Recorded

Problem disbursements—disbursements that are not properly matched to specific obligations recorded in the department's records—continue to impede the department's efforts to improve its budgetary data. This situation can misstate DOD's reported obligated balances, undermining this important budgetary control. For example, when disbursements are not matched to specific obligations, an understatement of obligations and an overdisbursement of an account can occur. This situation occurs if the disbursement is for an item for which an obligation has not been recorded or if the amount of the recorded obligation is less than the recorded disbursement. Obligations are also understated in the case of in-transits, in which a disbursement has been made but documentation is insufficient to determine how the transaction should be recorded in the accounting records. The elimination of problem disbursements is one of the department's highest financial management priorities. DOD has reported progress in resolving problem disbursements. As of September 30, 1999, DOD reported¹¹ \$10.5 billion in problem disbursements, including in-transits, as compared with about \$17.3 billion in problem disbursements reported at the end of fiscal year 1998.

Of the \$10.5 billion, DOD reported that about \$1.5 billion were problem unmatched disbursements and negative unliquidated obligations (NULOs)¹² over 180 days old. DOD's problem disbursement policy requires that obligations be recorded for amounts paid that are unmatched to a recorded obligation or exceed recorded obligated balances after 180 days. However, the policy makes an exception if sufficient funds are not available for obligation. In that case, DOD's policy permits the department to delay recording an obligation or adjustment until the funds cancel—up to 5 years after expiration of the account. DOD believes that by delaying the recording of the obligation, funds will become available—for example, through de-obligation—thus permitting the obligation to be recorded

¹¹Defense Finance and Accounting Service reports to the DOD Comptroller on problem disbursements and in-transits as of September 30, 1999.

¹²Negative unliquidated obligations (NULOs) are disbursements that have been received and posted to specific obligations by the accounting station, but the recorded disbursements exceed the recorded obligations.

without raising an Antideficiency Act concern and ensuing investigation. If DOD had recorded this \$1.5 billion after the transactions remained unmatched for 180 days, the related account balances would have reflected potential Antideficiency Act violations and required an investigation and report to the Congress if the appropriation is ultimately determined to be overobligated or overspent.

An agency may not avoid the requirements of the Antideficiency Act, including its reporting requirements, by failing to record obligations or to investigate potential violations. To ensure sound funds control and compliance with the Antideficiency Act, an agency's fund control system must record transactions as they occur. We and the DOD IG have previously reported¹³ on this issue and recommended that DOD revise its problem disbursement policies and procedures to ensure that accurate and reliable balances are maintained.

Finally, the process and control problems that result in the problem disbursement issues previously discussed also contribute to improper payments by the department. For example, our work continues to identify problems with overpayments and erroneous payments to contractors. For fiscal years 1994 through 1999, according to DFAS records, defense contractors returned over \$5.3 billion to the DFAS Columbus Center, including about \$670 million during fiscal year 1999, due to contract administration actions and payment processing errors. However, these amounts do not reflect the true magnitude of this problem because many overpayments are returned through billing offsets. We are currently working to estimate the scope of the overpayment problem, including these offsets.

Obligated Balances Were Incorrect and Unsupported

In their testing of obligated balances, DOD auditors found evidence of unsupported obligations and poor internal controls over obligations, as illustrated by the following examples.

- The Army Audit Agency found¹⁴ that internal controls over the recording of obligations were not adequate to ensure that reported obligated

¹³Financial Management: Problems in Accounting for Navy Transactions Impair Funds Control and Financial Reporting (GAO/AIMD-99-19, Jan. 19, 1999) and Recording Obligations in Official Accounting Records (DOD IG Report No. D-2000-030, Nov. 4, 1999).

¹⁴Army's General Fund Principal Financial Statements for Fiscal Year 1999, Financial Reporting of Budgetary Resources (U.S. Army Audit Agency Report No. AA 00-223, Apr. 28, 2000).

balances were accurate. In a sample of 60 1999 transactions, the auditors found that 21 could not be supported.

- For fiscal year 1999, audit results¹⁵ show that the Air Force Working Capital Fund had \$211 million of obligations out of approximately \$1 billion tested, that is 700 out of 2,526 transactions that were incorrect, inadequately supported, or not supported. In addition, Air Force's general fund audit continued to identify inaccurate or unsupported obligated balances as of September 30, 1999. Specifically, Air Force auditors identified an estimated \$1.3 billion in inaccurate or unsupported obligated balances, a significant improvement over the prior year when an estimated \$4 billion in obligated balances were inaccurate or unsupported.

In addition to auditors' reports, the Department of the Navy identified its unliquidated and invalid obligations as a material management control weakness in its fiscal year 1999 annual assurance statement issued pursuant to the Federal Managers' Financial Integrity Act.¹⁶ For example, the Navy reported that within the Operation and Maintenance-Navy appropriation, some activities were not verifying that only valid obligations were entered into the accounting system. As a result, funding may have been available but not used. In addition, the Navy had more than \$1 billion in expired budget authority that was allowed to cancel at the end of fiscal year 1999, including more than \$750 million that had been obligated but not disbursed. According to Treasury data, at the end of fiscal year 1999, the department had \$3.8 billion in expired budget authority that canceled.

Accurate and reliable information would permit the Congress to review DOD year-end unobligated and unexpended balances and identify opportunities for possible funding reductions. For example, as a result of our analysis of unobligated balances in the military personnel appropriation, the House Appropriations Committee recommended a reduction of \$96 million in the fiscal year 2001 request for this account. Since the military services' account data have shown a pattern of not spending all of their appropriated funds, the Committee concluded that the fiscal year 2001 military personnel budget request is overstated and can be reduced.

¹⁵*Opinion on Fiscal Year 1999 Air Force Working Capital Fund Financial Statements* (Air Force Audit Agency Report No. 99068011, Feb. 9, 2000).

¹⁶The Federal Managers' Financial Integrity Act of 1982 requires federal agencies to annually assess controls and report on internal control and accounting system deficiencies, along with the status of related corrective actions.

Improved Data on Environmental/Disposal Liability Would Be an Important Oversight Tool

Under federal, state, and international law, DOD faces a major funding requirement associated with environmental cleanup and disposal. These environmental costs result from the production of weapons systems and prior and current operations. Even when current operations are carried out in full compliance with existing environmental regulations, future cleanup costs for certain operations will still result due to the nature of these DOD activities. DOD has taken important steps to implement the federal accounting standards¹⁷ requiring recognition and reporting of these liabilities and has made noteworthy progress. For example, DOD's reported estimated liabilities increased from \$34 billion in its fiscal year 1998 financial statements to \$80 billion in fiscal year 1999. However, the full magnitude and timing of these costs are not yet known because (1) all potential liabilities were not considered in the reported estimates, (2) estimates were not based on the consistent application of assumptions and methodologies across the services, and (3) support for the basis of reported estimates continues to be inadequate.

A reliable estimate of DOD's environmental liability would be an important factor in determining the cost of its operations and specific programs and for resource planning. To effectively, efficiently, and economically manage DOD's programs, its managers and oversight officials need reliable cost information for the following key decision points.

Evaluating programs—Long-term liabilities that affect program costs must be accurately measured and considered in evaluating the status of programs. For example, the liability for disposal activity is part of the overall life-cycle cost of weapon systems and can contribute to the ongoing dialogue on funding comparable weapons. The National Defense Authorization Act for Fiscal Year 1995 required that the Secretary of Defense analyze the environmental costs of major defense acquisitions as part of the life-cycle costs of the programs. However, recent IG audits of several major weapons systems programs, including the Black Hawk helicopter and F-15 aircraft, have found that life-cycle cost estimates did not include costs for demilitarization, disposal, and associated cleanup.¹⁸

¹⁷Statements of Federal Financial Accounting Standards No. 5, *Accounting for Liabilities of the Federal Government* and No. 6, *Accounting for Property, Plant, and Equipment*.

¹⁸*Hazardous Material Management for the Black Hawk Helicopter Program* (DOD IG Report No. 99-242, Aug. 23, 1999) and *Hazardous Material Management for the F-15 Aircraft Program* (DOD IG Report No. 00-012, Oct. 15, 1999).

In addition, the Senate Committee on Appropriations has required that DOD develop disposal cost estimates for munitions.¹⁹

Making current economic choices—DOD's decisions on whether to outsource specific functions require accurate and complete supporting cost data. Yet DOD, as well as other government agencies, has historically been unable to provide actual data on the costs associated with functions to be considered for outsourcing. For example, environmental and disposal costs must be considered in the department's plans to analyze its more than 2,000 utility systems for privatization. If these costs prove significant to DOD, they should be considered in any cost-benefit analyses developed by the department in deciding to retain or privatize these functions.

Resource planning—Reliable information on the full extent of the environmental liability that DOD faces under current law and the likely timing of funding requests would enable DOD and the Congress to make informed judgments about DOD's ability to carry out those requirements. As the Comptroller General recently testified²⁰ before the Senate Budget Committee, although we are currently enjoying a period of budget surplus, it does not signal the end of fiscal challenges. Long-term cost pressures from programs such as Social Security and Medicare will consume an ever-larger share of the economy and squeeze the resources available for other commitments and contingencies, such as federal insurance programs and cleanup costs from federal operations known to result in hazardous waste, including defense facilities and weapons systems. Accurate and complete information on the magnitude and timing of DOD's environmental liability would permit DOD and the Congress to strategically plan for this long-term liability and set realistic priorities among the competing challenges that we will face in the future. Further, quantifying this enormous liability and providing a breakdown of the costs by the approximate time periods the disposal costs are expected to be incurred would add an important context for congressional and other decisionmakers on the timing of resource needs, including those that are

¹⁹ *Report on the Fiscal Year 1995 Defense Appropriations Bill* (Senate Committee on Appropriations, Senate Report 103-321, July 29, 1994).

²⁰ *Budget Issues: Effective Oversight and Budget Discipline Are Essential—Even in a Time of Surplus* (GAO/T-AIMD-00-73, Feb. 1, 2000).

more near-term. For example, we estimated²¹ that approximately \$1.6 billion of the \$5.6 billion estimate for the disposal of nuclear powered submarines was for submarines that are already decommissioned and awaiting disposal.

In summary, the most significant issues faced by the department in determining and verifying its environmental/disposal liability include incomplete estimates, inconsistent methodologies, and inadequate documentation.

Incomplete estimates—To date, DOD has focused on what it expects will be its most significant liabilities, those associated with nuclear weapons and training ranges. It has not yet considered the magnitude of costs associated with other weapon systems, conventional munitions, or its ongoing operations, although these costs may also be billions of dollars. For example, the department's costs to dispose of conventionally powered ships would be at least \$2.4 billion, based on applying the Navy's estimated average cost of \$500 per ton of displacement used to estimate disposal costs for its inactive fleet. In addition, we previously estimated that the conventional munitions disposal liability for Army alone could exceed \$1 billion.

Also, the costs of cleaning up and disposing of assets used in ongoing operations may be significant. Significant environmental and disposal costs are required to be recognized over the life of the related assets to capture the full cost of operations. We are working with DOD to assess whether operations, such as landfills and utilities (including wastewater treatment and power generation facilities), will ultimately have significant environmental costs associated with closure. For example, Edwards Air Force Base officials provided us with a landfill closure cost estimate of approximately \$8 million. This estimate excluded post-closure maintenance costs (such as monitoring) which are estimated to exceed \$200,000 annually over 30 years. To provide some perspective on the potential scope of these operations, the Army alone reported 65 landfills that, based on the Air Force estimated cost data, could cost nearly \$1 billion to close and monitor.

²¹The Department of the Navy reported an estimated disposal liability for all nuclear submarines, both active and inactive and awaiting disposal, of \$5.6 billion as of September 30, 1999. To determine the portion of the total reported \$5.6 billion liability that applied to inactive submarines awaiting disposal, we divided the \$5.6 billion by the total number of active and inactive submarines reported in the Naval Vessel Register to arrive at an estimated disposal cost per submarine of about \$49 million. Applying this average cost to the reported number of inactive submarines awaiting disposal, we estimated a cost of \$1.6 billion to dispose of decommissioned submarines awaiting disposal.

Cost estimates should also be refined for changes in cleanup/disposal schedules. For example, DOD reported a liability of approximately \$8.9 billion in its fiscal year 1999 financial statements for chemical weapons disposal. Initial estimates to comply with the United Nations-sponsored Chemical Weapons Convention were based on a 2007 completion date. However, we recently reported²² that while 90 percent of the stockpile could be destroyed by the 2007 deadline, schedule slippages associated with the remaining 10 percent are likely to occur because of additional time required to validate, certify, and obtain approval of technologies to dispose of the remaining stockpile of chemical weapons. These schedule slippages will likely result in additional program costs. Historically, schedule delays have been found to increase costs such as labor, emergency preparedness, and program management.

Inconsistent methodologies and inadequate documentation—Each military service independently estimated its liabilities with, in some cases, significantly different results, and the lack of documentation hampered auditors' ability to verify the estimates. For example, although the Air Force reported twice as many aircraft as the Navy, it has not yet reported environmental and disposal liabilities for its aircraft. The Navy's financial statements included an initial estimate of \$331 million in fiscal year 1999 for its disposal of fixed- and rotary-wing aircraft. In addition, our limited analysis of DOD's first-time effort to develop complete cleanup cost estimates for training ranges, which we view as an important step forward, showed that the reported amount of \$34 billion was comprised primarily of cost estimates for active, inactive, and closed Navy/Marine Corps ranges of approximately \$31 billion. The Navy reported this to be a minimum estimate based on assumptions of "low" contamination and cleanup/remediation to "limited public access" levels, for uses such as livestock grazing or wildlife preservation but not for human habitation. Based on these assumptions, the Navy used a cost factor of \$10,000 per acre. Although the Army also has significant exposure for training range cleanup liabilities, it reported only \$2.4 billion for ranges on formerly used defense sites and closed ranges on active installations. The Army assumed one closed training range per base for the active installations. However, because the Army has not developed a complete range inventory nor recorded any liability for active or inactive ranges, this approach may have significantly understated its liability. To illustrate the potential magnitude of Army training range cleanup, applying the cost factor used by the Navy to estimated range acreage of the Army's National Training Center at

²² *Chemical Weapons Disposal: Improvements Needed in Program Accountability and Financial Management* (GAO/NSIAD-00-80, May 8, 2000).

Ft. Irwin, California, would result in a cleanup cost estimate of approximately \$4 billion for that installation alone.

Further, DOD has had ongoing problems in adequately documenting its reported liability—an important control in ensuring its reliability. Last year, the DOD IG reported that the basis of estimates for significant recorded liabilities—primarily those related to restoration (cleanup) of sites contaminated from prior operations—was not adequately supported, and those problems persist. Military service auditors continue to find that significant portions of the reported restoration liabilities lack adequate support for the basis of cost estimates. For example, the Army Audit Agency found that the Army lacked support for its estimates and attributed it to the fact that recent guidance on documentation requirements was not properly disseminated to project managers and others preparing project cost estimates.

Better Estimates of Retiree Health Care Benefits Could Assist DOD and the Congress

DOD and the Congress are looking at numerous options to provide more—and more cost-effective—health care to military personnel upon their retirement. Currently, there are several pilot programs underway to test the feasibility of providing additional health care benefits to retirees over 65 years, including the Medicare Subvention demonstration and the TRICARE Senior Supplement project.²³ Congress is now considering expanding these pilot programs to cover greater numbers of retirees or extending the length of the trial periods. The Congress is also considering expanding coverage of certain benefits, such as for pharmaceuticals, to Medicare eligible retirees. Reliable financial and patient care data would enhance the ability of DOD and the Congress to consider medical care options.

DOD estimates that, based on its current benefit programs, the cost of providing future health care benefits for military retirees and their dependents will be \$196 billion;²⁴ however, we have previously testified²⁵

²³The Medicare Subvention demonstration allows retirees over 65 to use their Medicare benefit to receive care from DOD and Medicare will reimburse DOD for a portion of the cost of that care. The TRICARE Senior Supplement project allows older retirees to use TRICARE programs to supplement their Medicare coverage, including coverage of prescription drugs.

²⁴DOD's health benefits liability represents the present value cost of providing future health care benefits to current retirees and their dependents as well as to that segment of current active duty personnel and their dependents that DOD estimates will retire from the military. This estimate generally extends for the lifetimes or covered periods of eligible beneficiaries.

²⁵*Department of Defense: Progress in Financial Management Reform* (GAO/T-AIMD/NSIAD-00-163, May 9, 2000).

that this estimate is unreliable because DOD does not have accurate or complete cost and patient care information. DOD developed its estimate using an actuarial model that relies on historical information about the retiree population and the numbers, types, and costs of medical services provided to them. The model also uses economic, actuarial, and other assumptions, such as future interest rates and projected rate increases for medical costs. Improvements to the underlying data or assumptions can significantly change the liability estimate. DOD has made meaningful progress in improving the processes and underlying data on which its liability is based. For example, when better and more complete data about DOD's population, medical care costs, and outpatient clinic usage were used in the model in fiscal year 1999, the revised estimate was lower by \$37.5 billion, or nearly 17 percent, than the fiscal year 1998 estimate.

DOD has used its health care model to determine the long-term impacts of some benefit changes; for example, DOD recently calculated the long-term change in the liability of a proposal to provide eligibility for purchased care to retirees over 65. With better underlying data and some refinements to its methodology, DOD's model could be a valuable tool to both the department and the Congress for estimating the short-term, as well as long-term, budgetary impacts of complex changes to the retiree health benefits program. DOD has been using a similar model to calculate its long-term liability for military retiree pensions for many years, and both DOD and the Congressional Budget Office rely on the model to analyze the impact of changes to the retirement program.

As we testified in May 2000, DOD needs to improve the underlying data used by the model. First, DOD needs actual cost data for its military treatment facilities. DOD has been using budget obligation information as a surrogate; however, obligations do not reflect the full cost of providing health care because they do not, for example, include civilian employee retirement benefits that are paid directly out of the Civil Service Retirement and Disability Fund rather than by DOD. Nor do obligations include depreciation costs for medical facilities and equipment. In addition, DOD needs to improve the accessibility and reliability of its patient workload information. The DOD IG has reported²⁶ that medical services could not be validated either because the medical records were not available or outpatient visits were not adequately documented. The DOD IG also reported that outpatient visits are often double counted and that many telephone consultations have been incorrectly counted as visits.

²⁶Data Supporting the FY 1998 DOD Military Retirement Health Benefits Liability Estimate (DOD IG Report No. 99-127, Apr. 7, 1999).

An accurate count of patient visits by clinic and type is necessary for DOD to make the proper allocations of medical personnel, supplies, and funding. DOD has been working with the audit community on health care cost and workload data deficiencies and currently has several improvement efforts underway. DOD has been using examples of blatant data errors, such as negative costs for some surgery clinics and obstetric services provided to male patients, to stress to its own staff and to health care contractors the importance of its improvement efforts.

We are currently working with a contractor to assess DOD's retiree health benefits estimation methodology, and preliminary results indicate several areas where the model could be refined. DOD is currently assessing the feasibility and impact of making the following types of refinements.

- Pharmacy costs for retirees are currently not segregated from those of non-retirees, even though preliminary evidence suggests that retirees use more outpatient pharmacy resources. Also, the future trend rate used by DOD for pharmacy costs is the same as that for general medical costs, even though we previously estimated that DOD pharmacy costs increased 13 percent from 1995 through 1997 while its overall health care costs increased only 2 percent for the same period.²⁷
- In the past, DOD has assumed that numbers and types of clinic visits are adequate measures of outpatient health care usage for purposes of allocating health care costs to retiree and active duty populations; however, additional work may show that diagnosis related information is a better indicator of health resources usage because retirees may have more complicated diseases and therefore require longer and more resource intensive procedures.
- DOD's model currently does not calculate separate liabilities for retirees under and over 65 years old. DOD applies the same cost and economic assumptions to the two groups even though Medicare eligible retirees are offered different benefits than retirees under age 65 and therefore, their behavior, needs, and costs could be quite different.

²⁷ *Defense Health Care: Fully Integrated Pharmacy System Would Improve Service and Cost-Effectiveness* (GAO/HEHS-98-176, June 12, 1998).

Control and Accountability for Assets Impaired

DOD relies on various information systems to carry out its important stewardship responsibility over an estimated \$1 trillion in physical assets, ranging from multimillion dollar weapon systems to enormous inventories of ammunition, stockpile materials, and other military items. These systems are the primary source of information for (1) maintaining visibility over assets to meet military objectives and readiness goals and (2) financial reporting. However, these systems have material weaknesses that, in addition to hampering financial reporting, impair DOD's ability to maintain central visibility over its assets and prevent the purchase of assets already on hand. Overall, these weaknesses can seriously diminish the efficiency and economy of the military services' support operations. In addition, DOD's systems are not designed to capture the full cost of its assets, a major component in determining the total costs of its programs and activities. If reliable, such costs could be important tools for oversight and performance measurement.

Significant weaknesses in accountability and cost information for DOD's three major categories of assets include the following.

Weapons systems— The reported cost of this equipment in fiscal year 1997—the last year for which such information was reported on DOD's balance sheet—was more than \$600 billion. We have previously testified²⁸ that many of the military services' logistics information systems used to track and support weapon systems and support equipment were unable to be relied on. DOD continues to experience problems in accumulating and reporting accurate information on its national defense equipment.

For example, because the military services cannot identify all of their assets through a centralized system, each service had to supplement its automated data with manual procedures to collect the information. Items identified as a result of the fiscal year 1999 data call that were not included in the Army's centralized systems included 56 airplanes, 32 tanks, and 36 Javelin command-launch units. In addition, the military services have historically been unable to maintain information on additions and deletions for most of their national defense assets. While some progress has been made toward improving this data, auditors found that much of it was still unreliable for fiscal year 1999. Reliable information on additions and deletions is an important internal control to ensure accountability over assets. Without integrated accounting, acquisition, and logistics systems to provide accounting controls over asset balances, this control is

²⁸DOD Financial Management: More Reliable Information Key to Assuring Accountability and Managing Defense Operations More Efficiently (GAO/T-AIMD/NSIAD-99-145, Apr. 14, 1999).

even more important. For example, property managers should be able to review information on additions to ensure that all assets acquired are reported in logistics systems. If such a control is not in place, DOD cannot have assurance that all items purchased are received and properly recorded.

Because of the recognized problems with national defense asset information, the audit community in the past year focused on supporting and reviewing improvement efforts, rather than conducting any significant tests of data and systems. Under the National Defense Authorization Act for Fiscal Year 2000, the DOD Inspector General is required to review national defense asset data submitted to the Congress for fiscal year 1999. Such a review should help determine the success of DOD's improvement efforts so far, as well as identify those areas requiring further improvement.

In addition, DOD has acknowledged that the lack of a cost accounting system is the single largest impediment to controlling and managing weapon systems costs, including costs of acquiring, managing, and disposing of weapons systems. Accurate information on the life-cycle costs of weapon systems would allow DOD officials and the Congress to make more fully informed decisions about which weapons, or how many, to buy.

Properly accounting for the revenue associated with the sale of these assets has also been a significant financial management challenge. Since October 1998, we have issued four reports identifying internal control weaknesses in DOD's foreign military sales program that includes sales of national defense assets and services to eligible foreign countries. Most recently, on May 3, 2000, we reported²⁹ that the Air Force did not have adequate controls over its foreign military sales to ensure that foreign customers were properly charged. Specifically, our analysis of data contained in the Defense Finance and Accounting Service's Defense Integrated Financial System as of July 1999, indicated that the Air Force might not have charged FMS customer trust fund accounts for \$540 million of delivered goods and services.

In performing a detailed review of \$96.5 million of these transactions, we found that the Air Force was able to reconcile about \$20.9 million. However, of the remaining \$75.6 million, the Air Force had either

²⁹ *Foreign Military Sales: Air Force Controls Over the FMS Program Need Improvement* (GAO/AIMD-00-101, May 3, 2000).

-
- failed to charge customer accounts (\$5.1 million, 22 transactions);
 - made errors, such as incorrectly estimating delivery prices (\$44 million, 11 transactions); or
 - could not explain differences between the recorded value of delivered goods and services and corresponding value of charges to customer accounts. (\$26.5 million or 19 transactions).

Inventory—DOD's inability to account for and control its huge investment in inventories effectively has been an area of major concern for many years. In its fiscal year 1999 financial statements, DOD reported \$128 billion in inventory and related property. The sheer volume of DOD's on-hand inventories impedes the department's efforts to accumulate and report accurate inventory data. We reported³⁰ in our January 1999 high-risk report on defense inventory management that the department needs to avoid burdening its supply system with large inventories not needed to support current operations or war reserves. For example, our analysis of approximately \$63 billion of DOD's reported secondary inventory at September 30, 1999, showed that 58 percent of the reviewed items, or an estimated \$36.9 billion, exceeded these requirements. Further, during the fourth quarter of fiscal year 1999, only 2 of the Defense Logistics Agency's (DLA) 20 distribution depots reported accuracy rates above 90 percent, and overall accuracy was reported at 83 percent, with error rates ranging from 6 percent to 28 percent. DLA's goal is 95 percent accuracy. The lack of complete visibility over inventories increases the risk that responsible inventory item managers may request funds to obtain additional, unnecessary items that may be on-hand but not reported.

Control weaknesses over inventory can lead to inaccurate reported balances, which could affect supply responsiveness and purchase decisions, and result in a loss of accountability. For example, during a December 1999 visit to one Army ammunition depot, we found weak internal controls over self-contained, ready-to-fire, handheld rockets, a sensitive item requiring strict controls and serial number accountability. As detailed in our recently issued report,³¹ we and depot personnel identified 835 quantity and location discrepancies associated with 3,272 rocket and launcher units contained in two storage igloos. The depot had more items on hand than shown in its records because of control

³⁰ *Major Management Challenges and Program Risks: Department of Defense* (GAO/OCG-99-4, Jan. 1999).

³¹ *DOD Inventory: Weaknesses in Controls Over Category I Rockets* (GAO/AIMD-00-62R, Apr. 13, 2000).

weaknesses over receipt of items, and, in some cases, the records had location errors. Depot management responded immediately to our findings, and the depot subsequently accounted for and corrected the inventory records of all the rocket and launcher units. Regarding this problem, we identified potentially systemic weaknesses in controls and lack of compliance with federal accounting standards and inventory system requirements and made recommendations to the Army to establish and verify operating procedures to help ensure that systemic weaknesses are corrected.

DOD has long-standing problems accumulating and reporting the full costs associated with working capital fund operations that provide goods and services in support of the military services, its primary customers. The foundation for achieving the goals of these business-type funds is accurate cost data, which are critical for management to operate efficiently, measure performance, and maintain national defense readiness.

With regard to inventory cost information, federal accounting standards require inventories to be valued based on historical costs or a method that approximates historical costs. However, DOD systems do not capture the information needed to report historical cost. Instead, inventory records and accounting transactions are maintained at a latest acquisition cost or a standard selling price. Inventory levels are also reported to the Congress at latest acquisition cost. Although latest acquisition cost data may be important for budget projection and purchase decisions, this information may not be appropriate for performance measurement. Latest acquisition cost can substantially differ from the cost paid for the item. To illustrate how this occurs, assume a military service had 10 items that cost \$10 each, so each item would be valued at \$10, or at \$100 in total. However, if the service then purchased 1 new item at \$25, all 11 items would be valued based upon the latest purchase price of \$25, or \$275 in total. The former Commander of Air Force Materiel Command testified in October 1999 that such valuation practices distort DOD's progress toward reducing inventory levels and impact Congressional funding decisions.³² The Commander stated the following.

"Part of the problem was accounting policy. ...Each year, inventories of old spare parts were increased in value to reflect their latest acquisition price (the normal commercial

³²Statement of General George T. Babbitt, USAF, Commander, Air Force Materiel Command, Before the Subcommittee on Military Readiness, Committee on Armed Services, House of Representatives, October 7, 1999.

practice is to deflate, not inflate, the value of long term assets). Many supply managers who faithfully disposed of unneeded inventory were surprised at the end of the year to see their total inventory value increase. As a result, they were subject to great pressure to further reduce inventory levels. . . . The new spares were needed but funding restrictions prevented purchase of these parts for several years.”

Overall, the effect of increasing prices can be demonstrated by noting that the Air Force’s \$32.6 billion of inventory at latest acquisition cost is revalued to \$18.3 billion to reflect estimated historical costs.

Real and personal property—Audit tests of real property transactions, additions, deletions, and modifications that occurred during fiscal year 1999 indicated that DOD continues to lack the necessary systems and processes to ensure that its real property assets are promptly and properly recorded in its accountability databases. For example, Army auditors reviewed about \$408 million in real property transactions recorded during fiscal year 1999 and determined that \$113 million of those transactions should have been posted in prior fiscal years. Army auditors also identified \$43 million in unrecorded real property transactions.³³ In addition, recent audits by the military service auditors have continued to find that while DOD regulations require periodic physical inventories and inspections—a critical control in safeguarding assets—they are not always performed as required. Air Force auditors reported that real property personnel did not perform required inventories at 34 of 99 installations audited in fiscal year 1999. To illustrate the benefit of physical inventories, while implementing the Navy’s new accountability system, the number of assets recorded in the accountability database at one Marine Corps location alone increased by over 35 percent as result of wall-to-wall inventories.

In addition, because DOD does not have the systems and processes in place to reliably accumulate costs, it is unable to account for several significant costs of its operations, including its facilities and equipment. Comprehensive and reliable asset financial information is necessary for determining the full cost of operations and can be useful for anticipating the need for additional budgetary resources.

³³Army’s General Fund Principal Financial Statements for Fiscal Year 1999, Summary Audit Report (Army Audit Agency Report No. AA 00-168, Feb. 9, 2000).

An analysis of reported asset balances and related depreciation³⁴ can provide additional information to review specific budget requests. For example, the Navy reported that 85 percent, or approximately \$1.2 billion of its \$1.4 billion of depreciated equipment reported on its fiscal year 1998 financial statements, was fully depreciated. If Navy's financial information accurately reflected asset accountability and utilization periods, this information could be used as a factor in analyzing Navy's funding requests. Specifically, if the Navy's fiscal year 1998 information were accurate, it would indicate that most of the Navy's equipment is at or beyond its anticipated utilization period. This type of information could help support a funding request or, absent such a request, could be used to question whether operations would be impaired by the lack of needed capital equipment.

DOD Net Cost Information Is Unreliable

Our audit of the U.S. government's consolidated financial statements for fiscal year 1999 found that the government was unable to support significant portions of the \$1.8 trillion reported as the total net cost of government operations. Federal accounting standards require federal agencies to accumulate and report on the full costs of their activities.³⁵ DOD, which represents \$378 billion of the \$1.8 trillion, was not able to support its reported net costs. Although we have seen some improvements in DOD's ability to produce reliable financial information, as noted throughout this testimony and discussed in greater detail in my May 9, 2000, testimony, capturing and accurately reporting the full cost of its programs remains one of the most significant challenges DOD faces.

DOD needs reliable systems and processes to appropriately capture the required cost information from the hundreds of millions of transactions it processes each year. To do so, DOD must perform the basic accounting activities of entering these transactions into systems that conform to established systems requirements, properly classifying transactions, analyzing data processed in its systems, and reporting in accordance with requirements. As I will discuss later, this will require properly trained personnel, simplified processes, modern integrated systems supporting operational and accounting needs, and a disciplined approach for accomplishing these steps.

³⁴Depreciation recognizes the cost of assets over the estimated period of time they are expected to be used in operations, rather than at the time of acquisition.

³⁵Statement of Federal Financial Accounting Standards No. 4, *Managerial Cost Accounting Standards*, requires accumulating the full cost associated with an entity's output through appropriate costing methodologies or cost-finding techniques.

Because it does not have the systems and processes in place to reliably accumulate costs, DOD is unable to account for several significant costs of its operations, as discussed in this testimony. As I have highlighted today, the accuracy of the department's reported operating costs was affected by DOD's inability to

- complete the reconciliation of its records with those of the Department of the Treasury,
- identify the full extent of its environmental and disposal liability,
- determine its liability associated with post-retirement health care for military personnel,
- properly value and capitalize its facilities and equipment, and
- properly account for and value its inventory.

In addition, DOD did not have adequate managerial cost accounting systems in place to collect, process, and report its \$378 billion in total reported fiscal year 1999 net operating costs by program area consistent with federal accounting standards.³⁶ Instead it used budget classifications, such as military construction, procurement, and research and development, to present its cost data. In general, the data DOD reported in its financial statements represented disbursement data for those budgetary accounts, adjusted for estimated asset purchases and accruals. For financial reports other than the financial statements, DOD typically uses obligation data as a substitute for cost. As I stated earlier, DOD budget data are also unreliable.

To manage DOD's programs effectively and efficiently, its managers need reliable cost information. This information is necessary to (1) evaluate programs, such as by measuring actual results of management's actions against expected savings or determining the effect of long-term liabilities created by current programs, (2) make economic choices, such as whether to outsource specific activities and how to improve efficiency through technology choices, (3) control costs for its weapons systems and business activities funded through the working capital funds, and (4) measure performance.

³⁶Statement of Federal Financial Accounting Standards No. 4, *Managerial Cost Accounting Standards* (July 31, 1995) and *Internal Controls and Compliance With Laws and Regulations for the DOD Agency-Wide Financial Statements for FY 1999* (DOD IG Report No. D-2000-091, Feb. 25, 2000).

The lack of reliable, cost-based information hampers DOD in each of these areas as illustrated by the following examples.

- DOD is unable to provide actual data to fully account for the costs associated with functions studied for potential outsourcing under OMB Circular A-76. We reported last year on a long-standing concern over how accurately DOD's in-house cost estimates used in A-76 competitions reflect actual costs.³⁷
- DOD has acknowledged that its Defense Reform Initiative efforts have been hampered by limited visibility into true ownership costs of its weapons systems. Specifically, the department cited inconsistent methods used by the military services to capture support cost data and failure to include certain costs as limiting the utility of existing weapons system cost data. As noted previously, DOD has also acknowledged that the lack of a cost accounting system is the single largest impediment to controlling and managing weapon systems costs, including costs of acquiring, managing, and disposing of weapon systems.
- DOD has long-standing problems accumulating and reporting the full costs associated with its working capital fund operations, which provide goods and services in support of the military services. Cost is a key performance indicator to assess the efficiency of working capital fund operations. For example, we recently reported³⁸ that the Air Force's Air Mobility Command—which operated using a working capital fund—lacked accurate cost information needed to set rates to charge its customers and assess the economy and efficiency of its operations. We separately reported that Air Force depot maintenance officials acknowledged that they lack all the data needed to effectively manage their material costs.³⁹ As a result, DOD is unable to reliably assess the economy and efficiency of its business-like activities financed with working capital funds.

³⁷*DOD Competitive Sourcing: Lessons Learned System Could Enhance A-76 Study Process* (GAO/NSIAD-99-152, July 21, 1999).

³⁸*Defense Transportation: More Reliable Information Key to Managing Airlift Services More Efficiently* (GAO/NSIAD-00-6, Mar. 6, 2000).

³⁹*Air Force Depot Maintenance: Analysis of Its Financial Operations* (GAO/AIMD/NSIAD-00-38, Dec. 10, 1999).

Integrated Financial Management System Using Year 2000 Approach

Establishing an integrated financial management system—including both automated and manual processes—will be key to reforming DOD's financial management operations. DOD has acknowledged that its present system has long-standing inadequacies and does not, for the most part, comply with federal system standards. DOD has set out an integrated financial management system goal. Further, the department is now well-positioned to adapt the lessons learned from addressing the Year 2000 issue and our recently issued survey of the best practices of world-class financial management organizations⁴⁰ and to use the information technology investment criteria included in the Clinger-Cohen Act of 1996.

Integrated Financial Management System Needed

Establishing an integrated system is central to the framework for financial reforms set out by the Congress in the Chief Financial Officers (CFO) Act of 1990 and the Federal Financial Management Improvement Act (FFMIA) of 1996. Specifically, among the requirements of the CFO Act is that each agency CFO develop an integrated agency accounting and financial management system. Further, FFMIA provided a legislative mandate to implement and maintain financial management systems that substantially comply with federal financial management systems requirements, including the requirement that federal agencies establish and maintain a single, integrated financial management system.⁴¹

The department faces a significant challenge in integrating its financial management systems because of its size and complexity and the condition of its current financial management operations. DOD is not only responsible for an estimated \$1 trillion in assets and liabilities, but also for providing financial management support to personnel on an estimated 500 bases in 137 countries and territories throughout the world. DOD has also estimated that it makes \$24 billion in monthly disbursements, and that in any given fiscal year, the department may have as many as 500 or more active appropriations. Each service operates unique, nonstandard financial processes and systems. In describing the scope of its challenge in this area, DOD recognized that it will not be possible to reverse decades-old problems overnight.

⁴⁰*Executive Guide: Creating Value Through World-class Financial Management* (GAO/AIMD-00-134, Apr. 2000).

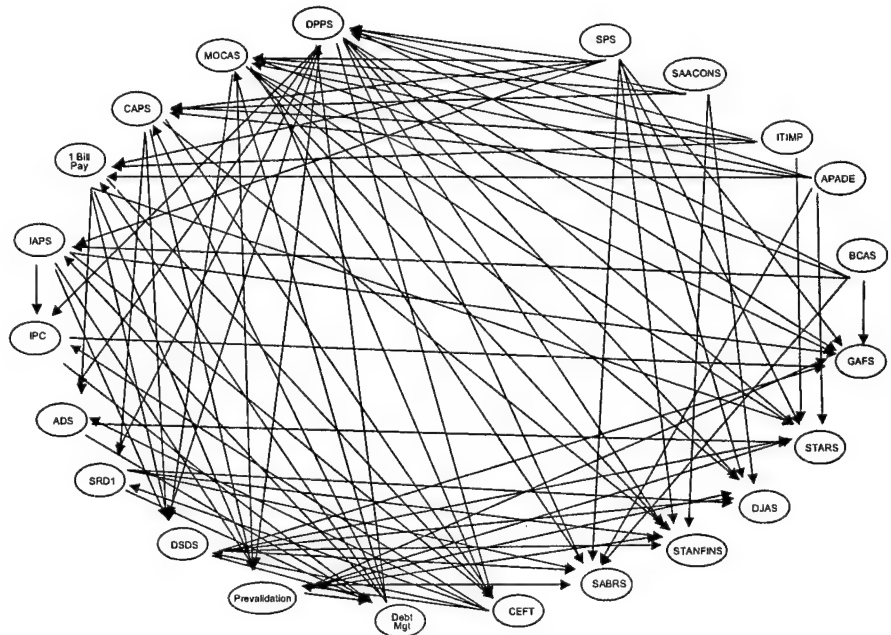
⁴¹Office of Management and Budget Circular A-127 defines an integrated financial management system as a unified set of financial systems and the financial portions of mixed systems encompassing the software, hardware, personnel, processes (manual and automated), procedures, controls, and data necessary to carry out financial management functions of an agency, manage financial operations of an agency, and report on an agency's financial status to central agencies, Congress, and the public.

DOD submitted its first *Financial Management Improvement Plan* to the Congress on October 26, 1998. We reported⁴² that DOD's plan represented a great deal of effort and provided a first-ever vision of the department's future financial management environment. In developing this overall concept of its envisioned financial management environment, DOD took an important first step in improving its financial management operations. DOD's 1999 update to its *Financial Management Improvement Plan* set out an integrated financial management system as the long-term solution for establishing effective financial management. As part of its 1999 plan, DOD reported that it relies on an inventory of 168 systems to carry out its financial management responsibilities. This financial management systems inventory includes 98 finance and accounting systems and 70 critical feeder systems—systems owned and operated by functional communities throughout DOD, such as personnel, acquisition, property management, and inventory management. The inclusion of feeder systems in the department's inventory of financial management systems is a significant landmark because of the importance of the programmatic functions to the department's ability to carry out not only its financial reporting but also its asset accountability responsibilities. The department has reported that an estimated 80 percent of the data needed for sound financial management comes from these feeder systems. However, DOD has also acknowledged that, overall, its financial management systems do not comply with the FFMA federal financial management systems requirements.

DOD presently lacks the integrated, transaction-driven, double entry accounting systems that are necessary to properly control assets and accumulate costs. As a result, millions of transactions must be keyed and rekeyed into the vast number of systems involved in a given business process. To illustrate the degree of difficulty that DOD faces in managing these complex systems, the following figure shows for one business area—contract and vendor payments—the number of systems involved and their relationship to one another.

⁴²*Financial Management: Analysis of DOD's First Biennial Financial Management Improvement Plan* (GAO/AIMD-99-44, Jan. 29, 1999).

Figure 1: DOD's Current Systems Environment for the Contract and Vendor Payment Process



Source: Department of Defense.

In addition to the 22 financial systems involved in the contract payment process that are shown in figure 1, DFAS has identified many other critical acquisition systems used in the contract payment process that are not shown on this diagram. To further complicate the processing of these transactions, each transaction must be recorded using a nonstandard, complex line of accounting that accumulates appropriation, budget, and management information for contract payments. Moreover, the line of accounting code structure differs by service and fund type. For example, the following line of accounting is used for the Army's Operations and Maintenance appropriation.

2162020573106325796.BD26FBQSUPCA200GRE12340109003AB22WORNAAS34030

Because DOD's payment and accounting processes are complex, and generally involve separate functions carried out by separate offices using different systems, the line of accounting must be manually entered multiple times, which compounds the likelihood of errors. An error in any one character in such a line of code can delay payment processing or affect the reliability of data used to support management and budget

decisions. In either case, time-consuming research must then be conducted by DOD staff or by contractor personnel to identify and correct the error. Over a period of 3 years, one DOD payment center spent \$28.6 million for a contractor to research such errors.

The combination of nonintegrated systems, extremely complex coding of transactions, and poor business processes have resulted in billions of dollars of adjustments to correct transactions processed for functions such as inventory and contract payments. As stated previously, during fiscal year 1999, almost one of every three dollars in contract payment transactions was made to adjust a previously recorded transaction. In addition, the DOD IG found that \$7.6 trillion of adjustments to DOD's accounting transactions were required last year to prepare DOD's financial statements.

DOD Adopts Year 2000 Approach

As we testified last year, DOD has a unique opportunity to capitalize on the valuable lessons it has learned in addressing the Year 2000 issue and apply them to its efforts to reform financial management. The Year 2000 approach is based on managing projects as critical investments and uses a structured five-phase process, including awareness, assessment, renovation, validation, and implementation. Each phase represents a major program activity or segment that includes (1) specific milestones, (2) independent validation and verification of system compliance, and (3) periodic reporting on the status of technology projects. During the department's Year 2000 effort, DOD followed this structured approach and (1) established interim dates or milestones for each significant aspect of the project, (2) used auditors to provide independent verification and validation of systems compliance, and (3) periodically reported the status of its efforts to OMB, the Congress, and the audit community.

To successfully adapt this structured, disciplined process to DOD's current financial management improvement initiatives, DOD must ensure that the lessons learned in addressing the Year 2000 effort and from our financial management best practices survey are effectively applied. In this regard, two important lessons should be drawn from the Year 2000 experience—the importance of (1) focusing on process improvement instead of systems compliance and (2) strong leadership at the highest levels of the department to ensure the reform effort becomes an entitywide priority.

End-to-End Business Process Focus

Establishing the right goal is essential for success. Initially, DOD's Year 2000 focus was on information technology and systems compliance. This process was geared toward ensuring compliance system by system and did not appropriately consider the interrelationship of all systems within a

given business process. However, DOD eventually shifted to a core mission and function approach and greatly reduced its Year 2000 risk through a series of risk mitigation measures including 123 major process end-to-end evaluations. Through the Year 2000 experience, DOD has learned that the goal of systems improvement initiatives should be improving end-to-end business processes, not systems compliance.

This concept is also consistent with provisions of the Clinger-Cohen Act of 1996 and related system and software engineering best practices, which provide federal agencies with a framework for effectively managing large, complex system modernization efforts. This framework is designed to help agencies establish the information technology management capability and controls necessary to effectively build modernized systems. For example, the act requires agency chief information officers to develop and maintain an integrated system architecture. Such an architecture can guide and constrain information system investments, providing a systematic means to preclude inconsistent system design and development decisions and the resulting suboptimal performance and added cost associated with incompatible systems. The act also requires agencies to establish effective information technology investment management processes whereby (1) alternative solutions are identified, (2) reliable estimates of project costs and benefits are developed, and (3) major projects are structured into a series of smaller increments to ensure that each constitutes a wise investment.

The financial management concept of operations included in DOD's *Financial Management Improvement Plan* should fit into the overall system architecture for the department developed under the provisions of the Clinger-Cohen Act. In addition, the goal of DOD's *Financial Management Improvement Plan* should be to improve DOD's business processes in order to provide better information to decisionmakers and ensure greater control and accountability over the department's assets. However, we reported last year,⁴³ the vision and goals the department established in its *Financial Management Improvement Plan* fell short of achieving basic financial management accountability and control and did not position DOD to adopt financial management best practices in the future.

Although the 1999 improvement plan includes more detailed information on the department's hundreds of improvement initiatives, the fundamental

⁴³ *Financial Management: Analysis of DOD's First Biennial Financial Management Improvement Plan* (GAO/AIMD-99-44, Jan. 29, 1999).

challenges we highlighted last year remain. Specifically, a significant effort will be needed to ensure that future plans address (1) how financial management operations will effectively support not only financial reporting but also asset accountability and control, (2) how financial management ties to budget formulation, (3) how the planned and ongoing improvement initiatives will result in the target financial management environment, and (4) how feeder systems' data integrity will be improved—an acknowledged major deficiency in the current environment.

For example, to effectively support accountability and control, DOD's plan needs to define each of its business processes and discuss the interrelationships among the functional areas and related systems. To illustrate, the plan should address the entire business process for property from acquisition to disposal and the interrelationships among the functional areas of acquisition, property management, and property accounting.

In its 1999 *Financial Management Improvement Plan*, dated September 1999, the department announced its intention to develop a "Y2K like" approach for tracking and reporting the CFO compliance of its financial management systems, including critical feeder systems. However, the department currently has hundreds of individual initiatives aimed at improving financial management, many of which were begun prior to the decision that a Year 2000 approach would be used for financial management reform. These decentralized, individual efforts must now be brought under the disciplined structure envisioned by the Clinger-Cohen Act and used previously during the department's Year 2000 effort. Doing so will ensure that further investments in these initiatives will be consistent with Clinger-Cohen Act investment criteria and that the department's financial management reform efforts focus on entire business processes and needed process improvements.

Because of the extraordinarily short time frames involved for the Year 2000 effort, the department rarely had the opportunity to evaluate alternatives such as eliminating systems and reengineering related processes. DOD has established a goal of September 30, 2003, for completing its financial management systems improvement effort. This time frame provides a greater opportunity to consider all available alternatives, including reengineering business processes in conjunction with the implementation of new technology, which was envisioned by the Clinger-Cohen Act.

Strong Department-Level Leadership

Lessons learned from the Year 2000 effort and from our survey of leading financial management organizations also stressed the importance of strong

leadership from top leaders. Both these efforts pointed to the critical role of strong leadership in making any goal—such as financial management and systems improvements—an entitywide priority. As we have testified many times before, strong, sustained executive leadership is critical to changing the culture and successfully reforming financial management at DOD. Although it is the responsibility of the DOD Comptroller, under the CFO Act, to establish the mission and vision for the future of DOD financial management, the department has learned through its Year 2000 effort that major initiatives that cut across DOD components must have the leadership of the Secretary and Deputy Secretary of Defense to succeed. In addition, our best practices work has shown that chief executives similarly need to periodically assess investments in major projects in order to prioritize projects and make sound funding decisions.

Improving DOD financial management is a managerial, as well as technical, challenge. The personal involvement of the Deputy Secretary played an important role in building entitywide support for Year 2000 initiatives by linking these improvements to the warfighting mission. To energize DOD, the Secretary of Defense directed the DOD leadership to treat Year 2000 as a readiness issue. This turning point ensured that all DOD components understood the need for cooperation to achieve success in preparing for Year 2000 and it galvanized preparedness efforts.

Similarly, to gain DOD-wide support for financial management systems initiatives, DOD's top leadership must link the improvement of financial management to DOD's mission. For example, DOD stated in its Defense Reform Initiative that improved business practices will eventually provide a major source of funding for weapon system modernization. This can occur through reductions in the cost of performing these activities as well as through efficiencies gained through better information. To ensure that this mission objective is realized will require top leadership involvement to reinforce the relationship between good financial management and improved mission performance. To build this support across the organization, many leading organizations have developed education programs that provide financial managers a better understanding of the business problems and nonfinancial managers an appreciation of the value of financial information to improved decision-making. As discussed below, DOD is taking these first steps in providing training to its financial personnel, and DOD officials have recently stated that their next annual financial management improvement plan will begin to address the need for financial management training for nonfinancial managers.

Strategic Human Capital Investment Integral to Reform

An integral part of financial and information management is building, maintaining, and marshaling the human capital needed to achieve results. While DOD has several initiatives underway directed at improving the competencies and professionalism of its financial management workforce, it has not yet embraced a strategic approach to improving its financial management human capital. Our recently issued guide on the results of our survey of the best practices of recognized world-class financial management organizations shows that a strategic approach to human capital is essential to reaching and maintaining maximum performance.

DOD's 1999 *Financial Management Improvement Plan* recognized the key role of financial management training in ensuring that the department has a qualified and competent workforce. The DOD Comptroller recently issued a memorandum to the department's financial management community emphasizing the importance of professional training and certification in helping to ensure that its financial managers are well-qualified professionals. Consistent with this recent emphasis, the department has begun several initiatives aimed at improving the professionalism of its financial management workforce. For example, DFAS contracted to have government financial manager training developed by the Association of Government Accountants provided to several thousand of its employees over the next 5 years. This training is aimed at enhancing participants' knowledge of financial management and can then be used to prepare for a standardized exam to obtain a professional certification, such as the Certified Government Financial Manager (CGFM)⁴⁴—a designation being encouraged by DOD management.

In another initiative, undertaken in conjunction with the American Society of Military Comptrollers, the department reports that it expects to have its own examination-based certification program for a defense financial manager in place in the near future. The department has contracted with the USDA Graduate School—a continuing education institution—to provide financial management training to an estimated 2,000 DOD financial personnel in fiscal year 2000 and thousands more over the next 5 years. The department reports that this training will be directed at helping participants to develop sufficient knowledge so that they can demonstrate competencies in governmentwide accounting and financial management systems requirements as they are applied in the DOD financial management environment.

⁴⁴The Certified Government Financial Manager (CGFM) is a government financial manager professional certification awarded by the Association of Government Accountants.

The department is faced with a considerable challenge if it is to improve its financial management human capital to the performance-based level of financial management personnel operating as partners in the management of world-class organizations. While DOD's financial personnel are now struggling to effectively carry out day-to-day transaction processing, personnel in world-class financial management organizations are providing analysis and insight about the financial implications of program decisions and the impact of those decisions on agency performance goals and objectives. To help agencies better implement performance-based management, we have identified common principles that underlie the human capital strategies and practices of leading private sector organizations.⁴⁵ Further, we have issued a human capital self-assessment checklist for agency leaders to use in taking practical steps to improve their human capital practices.⁴⁶

In closing, as we have noted throughout this testimony, DOD continues to make incremental improvements to its financial management systems and operations. At the same time, the department has a long way to go to address the remaining problems. Overhauling DOD's financial systems, processes, and controls and ensuring that personnel throughout the department share the common goal of improving DOD financial management, will require sustained commitment from the highest levels of DOD leadership—a commitment that must extend to the next administration.

Mr. Chairman, this concludes my statement. We will be glad to answer any questions you or the other Members of the Task Force may have at this time.

(924050)

⁴⁵*Human Capital: Key Principles From Nine Private Sector Organizations* (GAO/GGD-00-28, Jan. 31, 2000).

⁴⁶*Human Capital: A Self-Assessment Checklist for Agency Leaders* (GAO/GGD-99-179, Sept. 1999).

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E-mail: fraudnet@gao.gov

1-800-424-5454 (automated answering system)